

## 2011 CalPERS Sustainable Investing Workshop

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Segment: Sustainable Investing Workshop  
Host: CalPERS  
Guests: Jane Ambachtsheer (Mercer) and Rob Lake (PRI)

### Video Transcript

#### Segment 1: Welcome & Overview: Workshop Objectives

Board Member Jones:

Good morning. Our chair George is on his way so we're gonna get started anyway. Before we start with the workshop, I would like to just take a moment and welcome Michael Bilbrey the new CalPERS Board member recently elected. Michael, let's welcome Michael.

[Clapping]

Board Chairman George Diehr:

Go right ahead, you're doing great. I don't want to interrupt the flow here. Plus it's part of our training program.

Board Member Jones:

Okay, well welcome to the Board workshop on sustainable investing, integration of environmental, social and governance factors. ESG is a priority for CalPERS and our Board. We've had a long standing interest and commitment to it. Because as fiduciaries to the fund, we're well aware of the risk and reward opportunities surrounding ESG, from climate change to good governance practices to work-related issues. Our investment committee first approved a plan to begin looking at integrating ESG into our investment decision making two years ago. Since then, I know the investment staff has devoted a lot of time and energy to researching, analyzing and strategizing how best to incorporate ESG across all of our asset classes. So we're very much looking forward to today's review of all those efforts and we will be paying close attention to all the discussions we hear this morning. Today's session is designed to provide the Board with information and analysis. We will not be making any decisions today. Before we begin, I'd like to say a special thanks to Anne Simpson from the Global Equity Unit and her colleagues for all their hard work in organizing the integration process and this morning's workshop. I know a lot of careful thought and planning has gone into the discussions here this morning so thank you. Now I'll turn it over to our chief investment officer, Joe Dear.

Joe Dear:

Thank you Mr. Jones. Good morning members of the Board and the audience. Thank you for being here. We have a tradition of doing workshops at the end of the information and action presentation to the Board, but we decided to start this first to give the Board, while you're all fresh, a chance to really do a deep dive on

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a fascinating policy area. Henry mentioned the goal being information analysis but there's a significant component of this morning's workshop which is a discussion from the senior investment officers. And it's very much intended to be a discussion between them and the members of the Board. So I encourage you to interrupt at any time with questions. The value of this workshop will go up the more we interact with each other on that. And I will say no more with regard to the welcome, and turn it over to Anne Simpson who's led all the work on this. Anne.

Anne Simpson:

Thank you. Thank you Joe. Just to set the scene. We've got four objectives for this morning's workshop. The first is we want everyone to have some clarity about the current range of activity CalPERS is engaged with. It's a substantial area of work. It's a mapping out what we are currently doing. That's number one. Secondly, we want to think about the issue of relevance, among the many issues that matter; where do we have capacity and where is there potential for impact on...

Unknown:

Excuse me. They say they can't hear in the back at all.

Anne Simpson:

Can you hear? I apologize. We've got four objectives for this morning's workshop. The first, to establish clarity about the full range of CalPERS current work in this area. The second is to have a discussion about relevance, what are the issues where CalPERS has capacity and also, where there is potential impact on sustainable risk and return. Linked to that, we'd like to begin the process of establishing priorities and look at area of focus, the sequence in which we need to approach issues, and how best to coordinate these across the portfolio. And finally we want to set the stage for implementation. We'll come back to the investment committee with an implementation plan later this year. But ultimately it's our intention to be practical. Today, it's ideas, it's analysis, and we'll follow with an implementation plan after we've had the Board's input. I think we had a good summary of how this initiative came about in Mr. Jones' opening remarks so the second slide I think we can leave. I'm delighted this morning that we've not only got the heads of our asset classes and head of risk and asset allocation. This is extremely important to have the senior investment team here in this setting, presenting their ideas. But we also have two external speakers. Jane Ambachtsheer, who has been leading the team at Mercer who have been supporting us in this work, and Rob Lake. He's formally the head of sustainability at APG, one of the biggest funds in Europe. And Rob is the newly appointed director of strategy at the PRI. So they're going to give us a framework for thinking about this whole body of work. I'm then going to give you the highlights from the process and the conclusions that we've come to at this stage. And then each of the asset class heads is going to give you their take on what the

priorities, performance and procurement issues are for that particular asset class. And then Joe will wrap it up for us looking at next steps.

## **Segment 2: Developing a Total Fund Process for Integrating ESG Factors**

So, let me turn to Jane and to Rob to give us some framework on the bigger picture of ESG and the world of investment. Jane.

Jane Ambachtsheer:

Great. Thank you very much Anne. It's a pleasure to be here today and it's been a pleasure to work with CalPERS on this project over the last year. So the question of evidence, assessing the evidence, is a question we get frequently at Mercer as institutional consultants working with a range of clients on this. As investors approach this area, one of the first questions is, what does the evidence say? Does it say things which I should be concerned about or does it say things which should encourage me to look further at this area. So it's an area that we've spent some time looking at. And I think really in terms of setting the stage, one of the first important points is that there are a range of different approaches towards integrating environmental, social and governance factors into investments or ESG factors. Whether it's active ownership, whether it's into equity or fixed income approaches, whether it's active or passive. And the range of literature addressing the different approaches is growing. So there really is a growing body of literature and a growing set of theories which underpin the way that ESG is integrated. I think another key point is that because it's a relatively new area, a lot of the evidence that's out there has been done and published by practitioners. So, the academic evidence is following and it's growing and there is a growing body of that. But really I think it's important to look both at the practitioner and the academic literature when addressing this area. So we have done a number of pieces of work which review this literature overall, and just to talk through some of the key, the key points, I think is interesting in terms of looking at attribution and looking at risk and return overall. So one of the studies which we reference in here talks about from Staman, talks about the wages of social responsibility and looks at two different things. Looks at whether integrating ESG so taking into account companies which perform well on these metrics can have a positive impact on performance. And it does find that that's the case. But on the flip side it finds that screening out companies simply because of the type of activity they're involved with can detract from performance. And I think that's an interesting study because it really shows the two different flip sides that people are looking at and the evolution which CalPERS is looking at towards integrating ESG into that decision making process and that analysis. On the fixed income side, there's some interesting work from Bauer and Hann which shows that environmental considerations can be linked to a lower cost of capital for firms. On the social side, the same authors have looked at employee relations and the corporate performance around employee relations and employee satisfaction. And again finding a link to cost of capital

from that perspective. And Virtcom research that CalPERS has commissioned around diversity has shown a relationship between diversity at the Board level and performance and certain financial metrics. Again, trying to tackle kind of the group think and diversity from the perspective of really integrating around sustainability from a longer forward looking time horizon. Likewise from the CalPERS perspective is the CalPERS effect which of course is highly recognized and cited research around the impact of the focus list engagement. There is additional research on the governance side and really that's the area that's had the most study versus the environmental and the social findings. Both looking at the impact of investor engagement through different mechanisms, as well as the relationship between company performance on corporate governance mechanisms or metrics and company performance on financial metrics. Moving to the next slide.

I think if you look across, yes.

Board Member:

When people propose to put limits on our portfolio in Sudan, etc. we always say that by limiting our range of options you increase the risk or reduce the return. How does that not apply, you know, that same standard not apply when we consider the ESG factors?

Jane Ambachtsheer:

I think there's a very important distinction in terms of identifying activities that you don't want to have anything to do with. And simply screening out companies from your portfolio, versus kind of broadening the investor tool kit in terms of looking at how you analyze companies for those companies that you do want to include in your portfolio. And I think that things are changing in terms of how the market is looking at some of these different companies and the different strategies around sustainability that different companies are integrating into their business plans. And I think that right now there's a gap in the market in terms of the fact that you can do, go through the CFA program and go through an MBA program and not develop the tools in terms of looking at how something like performance on carbon or performance on water could link into financial performance. So I think that using a broader tool kit, looking at issues around company diversity or company performance on environmental indicators can just improve the way that you can make your investment decisions. And that's what a lot of the evidence is suggesting, that there are relationships between these factors which weren't historically necessarily the case or weren't historically looked at.

Board Member:

Thank you.

Jane Ambachtsheer:

And I think that touches on an interesting point actually that a lot of the research so far while it's growing, it doesn't necessarily go as deeply as it needs to. I think that there's still work to be done. For example, you know the key performance indicators around sustainability for a company will vary by sector. It will vary on, in sectors where companies are heavily regulated versus not heavily regulated. And the evidence suggests that it varies by market. Where sustainability and expectations for company performance are more embedded, for example in Europe than they are in the United States. So there are a lot of factors that need to be taken into account when addressing this. And I think that a lot of the work that's out there done by practitioners and academics is useful for an organization like CalPERS in thinking about your own approach, but they don't put forth the strategies which you're necessarily going to replicate. They just help to understand what the growing tool kit is and how to approach that.

Some of our findings is that there are gaps in the literature. There's more evidence historically, or not evidence, there's more academic work that's been done on screening. There's more academic work that's been done on governance, not as much in these other areas. It's also a finding that you know, a lot of this at the end of the day comes down to manager skill and manager strategy. That, while there are useful indicators on any financial theory, it's really how you put those into place when you're implementing that matters at the end of the day.

Looking at the next slide, we, we've done a couple kind of metastudies where we've brought together academic literature. And these are actually, to be frank, quickly becoming out of date because so much literature is coming out now. But on the whole most of the studies, 86 percent of the studies are either neutral or positive. And again what that means is that that the hypothesis of each of those studies which will vary, some of them are about hedge fund activism and its impact on share price. Others are around employee, employee satisfaction and the relationship with share price performance. On the whole, most of those relationships were found to be positive but that's not the case in every instance. And more recently, there are studies which are coming out, for example in the, the real estate space. A number of studies have come out by Gary Pivo and Neals Cox linking the performance on both rent and asset, asset value perspective of real estate properties which are LEED or energy star certified, as having higher rent and asset values. A number of studies from that perspective in the real estate space. A little bit of emerging evidence is coming through on the infrastructure space, again from practitioners. So there is a lot of kind of, a lot of momentum in this area, a lot of interesting work that's being done. The PRI academic network which is a group of practitioners and academics working in this area now has 400 members. Which is a huge number compared to just a few years ago. And I think actually there could be an interesting opportunity for California to host one of the PRI academic network conferences which happen twice a year around different parts of the world.

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So to sum it up, I think from the academic perspective two points. One, this is kind of a growing area and there is evidence from, from kind of the literature perspective and from our perspective at Mercer to suggest that looking at ESG factors is an increasingly part, important part of the investor tool kit. And it's one that necessarily, won't necessarily dictate how you invest, but it may influence how you invest. And from that perspective, it's an important tool to have access to and to utilize. It's one that CalPERS has tapped into before. And I think just systematically looking at tapping into from a broader perspective or exploring that opportunity.

The second point is that looking ahead it would suggest that sustainability drivers like climate change, resource scarcity, demographic change, are gonna become more rather than less important. So as a fiduciary looking at how you integrate those factors, and think about those factors from your investment process today, in advance of them becoming more impactful tomorrow, is a prudent thing to do. With that I'll hand it over to Rob.

Board Member:

I have a question please. Or a comment.

Jane Ambachtsheer:

Sure. Sorry.

Board Member:

In talking about the academics side, and you're right, there are more and more approaches. I recently read an academic article on the CalPERS effect which I think has paralleling interest in what you're talking about here because this academic, more recent article said the CalPERS effect no longer justifies any kind of alpha concern because, and it makes sense, it migrates to the norm. Is when you first started it, it was effective and companies knowing that they might be on that list started taking actions. And then the CalPERS effect kind of spread globally and others are just, we automatically expect it. So as we look at these, and we'll address it as you go through these I guess, is that when we look at the environmental, social and governance parts, is, you would think that every investment fund, every pension fund is there, is going there or will have to go there and then at some point, so in the early stages, you know, I guess I would ask us is by really pushing this, do you, do you expect some higher returns because of that. Do you expect a greater position of sustainability. And in time you might get that on the front side but eventually it flattens out just like technology does. And it just becomes part of the norm, or is that always going to be just a growing thing. What is considered environmentally just today may not be the same effect tomorrow, and that is there any reason that we would think that a pension fund as large as ours in the United States, that five years or seven years or eight years from now, a Chinese investment fund with the same size wouldn't do and take on the same kind of issues. So it's kinda, it comes down to the alpha beta thing is you do this, what are we really expecting. Are we

expecting it to just sustain ourselves or are we expecting to pick up a little alpha out of it. You know.

Jane Ambachtsheer:

Yeah. I think it's a wonderful observations and I agree with you. I think that we have a little bit of a gap right now where things are changing, the way companies are reporting and being monitored is changing. And it takes time for markets and the investment community to catch up and to systematically integrate that into how they monitor and manage their money. So when it all does get factored in, it will go away. So I think that the investment organizations which are taking it into account now, are doing so because they want to have that competitive advantage over that kind of medium term. And the CFA Institute right now is looking at integrating ESG more fully into their curriculum. But they have 100,000 members. You know, it's gonna take time to trickle down and sink in. So do you want to be ahead of that curve, or behind the curve in terms of an investor looking at markets and integrating those factors, is really the question. And I think in ten years it will be more embedded. It's not to say there won't be new emerging issues which aren't yet embedded, like things will continue to change. But I think there will be that integration. I think though another point is that issues like climate change, you know, and Farouki may speak about this in terms of the climate change study, is that the biggest risk driver that we found through that study is climate policy is the biggest risk driver facing pension funds. It's not the physical impact, it's not the upside of new technology. It's what's gonna happen around climate policy and when, and will the market expect it. And so no one knows what will happen, but you need to have a system in place to be watching that. So that you can defensibly position yourselves. And so that's something where we don't know what's gonna happen to you, it's impossible to say if it'll get embedded or what time horizon.

Anne Simpson:

Rob, why don't we turn to you. What's happening, I think we have a slide page 6, looking at where this whole agenda is heading and I think that's a very good link with that point of discussion just now.

Rob Lake:

Thank you Anne. Good morning everybody. Thank you for the invitation to be with you this morning. It's a pleasure and a privilege. Maybe just an introductory comment on, by way of bridge as it were between Jane's remarks and mine. Jane was talking about that growing body of academic evidence suggesting that there are strong and positive links between ESG factors and risk and return and different types of strategy and different asset classes. All that work, I think I'm right in saying, correct me if I'm wrong Jane, all that work has looked at entire portfolios. An equity portfolio or a fixed income portfolio. So rather top down. Looking at it bottom up, almost from a common person's perspective as it were, recent events, tragically in some senses, tell quite a compelling story about different types of situations in which different environmental, social or

governance factors can be, can certainly become powerfully financially relevant. So if you just think about BP for example. It's hard to escape the conclusion that it probably would've been valuable for investors to have known more, to be looking harder at BP's ability to manage safety and environmental issues in order to try to take an appropriate position ahead of time. There was information available in the market but most investors tend not to look in that direction, looking at things like safety practices and so forth. Similarly, with Massey for example, again hard to escape the conclusion that understanding safety management and employee issues better at that company would have been valuable. News Corp and corporate governance, a lot of people were of course including CalPERS trying to remediate corporate governance at Newscorp and have been trying to do so for a long time. But maybe if more people had tried harder for longer periods, some of what's happening now wouldn't be happening, or it might not be quite as extreme. So, essentially in my mind, what we're talking about is not pre, not necessarily predetermining a specific outcome, a specific type of investment decision that might be taken. We're talking about making sure that investors have the right range and breadth and depth and quality of information available on the table on which they can draw in order to then make investment decisions. The particular investment decisions will be determined by each fund circumstances. The, at the top level, the asset and liability situation you find yourselves in. The asset allocation that flows from that. The particular investment strategies within individual asset classes. So whether you're passive or top down or bottom up or whatever it might be. The individual investment decisions will be determined by each fund circumstances. But against the background of a recognition that these environmental, social and governance factors in different ways and different sectors and markets, can prove to be profoundly relevant and need to be understood. By definition they can't be acted upon unless the information is there. So the first stage is to ensure that processes are put in place to collect the right data, in order then to act on the data in whatever way is appropriate for each fund and it's circumstances. And looking around, I find myself in a strange and rather privileged position now, having worked in Europe as Anne said for one of the largest funds. And now up here I'm looking across the global landscape. It's certainly true that some of the largest funds and some of the smaller funds too, are moving from the earlier stage represented if you'd like by the left hand side on this slide, of rather disconnected, disjointed approaches, some of them frankly really not very keyed into core investment practice. Core investment practice as represented by an institution like CalPERS. Moving from that towards a much more holistic integrated way of looking at these issues. Acknowledging that underlying observation as I was saying just now, that for all the complexity, it seems pretty clear that these things can sometimes matter quite a lot. And in order to capture the full value from that insight, whether that is in terms of increasing return or reducing risk, addressing some of the kinds of issues that you were raising, to capture the full value from that insight and a strategic integrated approach across the whole portfolio is required to ensure that people in different parts of the portfolio are receiving the high quality information they



need. Working together to capture synergies from sharing information across asset classes in a way which I've seen it first hand from my own experience at APG doesn't always happen quite as effectively and efficiently as it should. I'm sure things are much better at CalPERS. But actually, an observation from experience, the very process of starting to look at ESG more strategically and in a more integrated way at APG did in a completely unforeseen way, stimulate a far higher level of interaction across team working more generally across the portfolio at APG than (inaudible) to prevail. So that was rather unexpected. But the key point is that if we accept the premise that these issues, albeit in different, multi-dimensional and complex ways, can prove to be pretty significant under certain circumstances. Then seeing it in an integrated and strategic way is the, is the approach that the world's leading funds are now taking to extract the greatest value from that, from that perspective. And the way that CalPERS is framing it it seems to me, if you'll allow me to comment on that, using the term sustainability, not just in the environmental sense, but thinking in terms of the financial sustainability of the fund and seeing ESG work as being absolutely integrated and central to the concept of the funds core business, if you'd like, and risk and return delivering the return to meet the liabilities on behalf of the beneficiaries, is, is I think actually a step forward in the, as it were, the discipline of ESG and bringing it in a much more holistic way into the core of what large, and indeed smaller, funds exist to do in the world as it were. So, for me it's a privilege to be here and I certainly wish CalPERS well in its endeavors.

Anne Simpson:

Thanks very much to both of you.

### **Segment 3: Total Fund Strategy for Environmental, Social & Governance**

Anne Simpson:

What I'd like to do now is turn to slide seven and briefly explain what we've been doing over the last year and a half. In terms of developing strategy in this area for integration we thought we ought, first of all, to learn more about what our global peers are doing. CalPERS has been at the forefront in this area for many years and very active in different groups like PRI. But we essentially wanted to benchmark in quite a deep way what we're doing asset cost by asset cost. So on slide seven you can see the list of funds that were willing to work with us on this in a peer exchange. For CalPERS to talk about what we're doing and likewise for them to share what they're doing. We didn't just focus on the success stories. We also wanted to talk about some of the problems and the difficulties and share ideas about solutions. That's proved to be very valuable. We took great care to ensure that the group was global, and the reason for that is of course our portfolio's global. And some of the most useful insights came from our peers such as the Government Employees' Pension Fund in South Africa, the Previ Fund in Brazil, and we learned a great deal from them as we did with the

Europeans and the other North American funds. The conclusions are set out briefly on slide eight. First of all, that CalPERS has areas of great strength. We've got activity in a broad range of asset classes, for example some funds have just said wow, this is an issue for global equity but not for anywhere else. We've got a lot going on. And also there was a conclusion that CalPERS has been innovative, has been willing to explore new issues, new areas and to lead. And also been willing to change direction when things haven't worked to step back or change their approach. CalPERS has also clearly experimented and developed new investment strategies through targeted investment programs in a wide range of areas. CalPERS was also seen to be a leader on the issue of engagement with companies, for example through the Focus List Program. But also in Market Reform. The point that Jane made on climate change is well taken. This is something where we have recognized we need to talk to regulators and policy makers and it's going to be a market solution. It isn't going to be something we can negotiate individually with companies. CalPERS has also got a very good track in the area of developing standards like the ILPA work and the Aim private equities space and also fixed income where the fixed income team have been extremely active through the credit roundtable. Just as examples. We have CalPERS chairing the Council of Institutional Investors through Joe and co-chairing series. Priya recently elected to the Board of PRI. Lou actively co-chairing a committee ICGN. So really CalPERS has got great strength and breadth in that area.

The benchmarking though did highlight some opportunities for us to raise our game. First, and I think this has been set out well in Rob's remarks, we have the opportunity to develop a total fund policy. It would tie this together, give us a framework and a consistent approach, and allow us to improve the synergy between the asset classes on this agenda and probably improve the quality of what we're doing. We also have an opportunity to establish a framework for monitoring. At the moment we have a wide range of activity but we don't have a framework for checking in on whether we're meeting our objectives or identifying what the matter, the matters might be that we should be looking at. Linked to that, we see an opportunity to publish a sustainability report for the total fund. We have some areas of work which were very well reported on and others which are simply not communicated. And there's an opportunity to tie that together. We also see linked to that an opportunity to build on the cross asset class team which has been put together for this project, and I'd like to acknowledge the tremendous amount of work across the asset classes in putting this together. That group has been productive and fruitful and we, we think there's an opportunity to use that network within CalPERS to build out staff education on the issue.

On slide nine, I think this is probably just a point for information. In establishing clarity about what we're doing, we asked Mercer to catalog everything that CalPERS has been doing. And you'll see in tab two there's an appendix B in which you can have a glimpse listing out everything that's going on in this arena.

There are over 100 separate initiatives that have been drawn together in this catalog, in this inventory. Which range from mandates, activity around compliance with legislation, endorsements and guidelines, capital commitments, engagement activity and work-developing standards. It's an impressive body of work. In looking at all of this very broad range of work, we see three themes surfacing. On environmental issues, a theme which surfaced across the asset classes was climate change. You can see it's been approached in different ways but climate change is clearly something which is considered by all the asset classes to have some relevance. The second unifying theme, perhaps under the social, the "S" in the social dimension of this work, relates to human capital. The issue of fair labor practices, and good employee relations, health and safety, responsible contracting, diversity are just examples. And under "G", the governance part of this agenda, the unifying theme that surfaced has been considering alignment of interest. So for every asset class, when contracting with external managers, alignment of interest is clearly fundamental and both AIM and Real Assets have been doing extremely important work in this area. But for other asset classes like global equity, alignment of interest is expressed through for example our concern with executive pay. Clearly not in our interest to pay more than is necessary to recruit and retain the right people in companies. So an alignment of interest with our beneficiaries, which we pursue through our voting and engagement process. Please.

Board Member:

You know as we go through, I just want you know my question this morning, when I read this, I am very pro this so don't, please don't take any questions anything other than that, except to cause us to think a little bit. As we go along and Peter's sitting over here and you can almost, you talk about an academic paper about the fiduciary conflicts, the inherent possible fiduciary conflicts with some of these issues as they progress because for example, we can think of our own history and the history about the pension funds if we look back just five years where we had investments that, because of our limited partner status, investments that were not, ended up to be in the alignment of our interest. You could have investments where we were asked to remove our self from certain areas, weave out some fiduciary responsibility to make sure how that happened. So I guess as we adopt, adapt and go through this, is that I, that would be Joe and Peter and that, to always be advising the Board. We have to look at, because you could have an, just to use an example, an extreme philosophy about a particular thing that you think is gonna have an effect 20 years from now. But the fiduciary responsibility to maximize investment right now maybe in conflict with that, and I guess we need to keep, is how do we address those issues as we go along? Because I see some inherent conflicts in the short-term. Not in the long-run but in the, certainly in this short-term. By short term, one, three, five years, where you may have investments today that you wouldn't be in 10 or 15 years because they would be in conflict with this spot. But to not be in them right now would be in conflict of your fiduciary responsibilities. Just keep that in mind please.

Jane Ambachtsheer:

If I might just on that point, and I don't want, I know we've got a very tight agenda. I don't think it's ever a bad idea to consider information that can better inform your investment decision. So I mean I think Rob's points this morning were very well taken that it's not predetermining an investment decision, but incorporating into your investment processes how do you think about some of these risks that we really haven't adequately considered before. And so in my mind this is all very consistent with fiduciary duty. In fact, it's a requirement really if you think about it, that we consider all of the risk factors that might effect an investment decision when we can.

Board Member:

Yeah and on unifying theme issue, you made reference to the 111 separate initiatives that we have but as you go forward just looking at some of the existing initiatives we have regarding responsible contracting, diversity, when you unify, are you talking about evaluating those initiative or are you just going to recategorize those into these new themes? Or would each of these new things be evaluated to determine whether or not modifications are made to them, etc.?

Anne Simpson:

What we envision is following today's discussion, that we develop a framework and that framework would be a way to prioritize in the wide range of activity what we're doing, to give us immediate, medium and long-term goals within that to say what are our key performance indicators, and ensure that we're consistent. So if we're taking an approach in one area, that it's not different from, or perhaps it's only complimentary to activity on the same theme. So that is precisely where we will go. We see this as a way of building on the activity that's there. Evolving to a higher quality and to be more transparent and better coordinated out of which our goal is to have a more effective strategy than we have at the moment. I think when the early stages of anything, a profusion of activity and experimentation and new ideas, that's fine. I think we're at the stage now where in this area we need to be thinking about integration and that means consistency. And I'll just turn to the next slide and I'll explain how we're going to do that or how we'd like to go about doing it if you agree.

So before I do that slide 10, one of our proposals we'll come to in a moment is that we think about this agenda as sustainability rather than E or S or G or any other letter of the alphabet. Or even responsible investment. Because it's rather odd to say responsible investment when the opposite would be unthinkable for a fiduciary. The reason we like the term sustainability, is that it inherently captures the financial duties of a fiduciary investor. Sustainability in its simple form is the ability to continue and for a long term investor like CalPERS with long term liabilities, the ability to continue financially is the prime duty of the fund. And therefore if we think about sustainability, environmental, social and governance factors are ways to improve that sustainability objective. So this would be, rather

than seeing these as individual projects that may add to risk or may add to return, we actually think of the environmental, social and governance aspect of what we do as simply part of improving the sustainability of the returns that are required.

We turn to page 11. The way that we've worked is following our discussions with our global peers, we've then sat with the teams in each of the asset classes and discussed what could be done next or what their priorities are. I think that's very important to say we've approached this as a bottom up exercise because our goal is to make sure this is integrated with the strategies and the priorities, the objectives of each of the asset classes. So the priorities that you're going to hear about set out for each of the asset classes have been generated by the teams and the SIOs who will present their ideas to you in a moment. The second objective that we've had in this work is really to work out the areas of research and inquiry that need to be undertaken in order to improve the quality of information. The review that Mercer's carried out for us was quite clear. We've got good evidence, reasonable data, in certain aspects of this work. In other areas, what's there is inconclusive or we simply don't know because the work's not been done. So we've taken a sort of cross-cutting second theme, our second "P", is that we want to identify quality data and key performance indicators. It says on the slide, link to long-term investment objectives, but I take our point, as Jane said, in the long-term we're all dead, this is why the short-term matters. Which is not true for pension fund. But we do need to be thinking about appropriate time scales so that comment needs to be modified. The third P that we've asked each asset class to think about is the "P" for procurement. If we consider that these issues can influence the quality of our risk management, if they can have an impact on the quality of returns, then we should be consistent in that approach. So that whenever, wherever, however CalPERS allocates capital, we have clearly understood how to approach this element of the decision that needs to be made. So the third "P", cutting across the portfolio that we think there's good work still to be done is on procurement, and we're saying there's an opportunity to develop a framework for external management and services that will allow us to first of all ask the right questions. In some areas we do, in others we don't. If we ask the right questions, we're in a position to develop some monitoring around the activity. And thirdly, to then have information which can be channeled into the total fund report, which we think it's time for us to put together.

Board Member Jelincic:

Anne, framework for external management. Is there a reason that it's not external and internal?

Anne Simpson:

No, but it's an interesting question. Procurement suggests external procurement. But if we have our internal strategies that's the foundation. The external strategies should be consistent with those. It would be very odd to be asking our

external managers to do something that our internal team thought was a bad idea for their own portfolios. True enough.

Board Member:

Excuse me, before we go into, quick comment. It seems to be and I think you've touched on this in other places, is that there are other, some of the other dimensions of this which would be standards, efforts, policy, advocacy as we do in our governance. So that, I don't know if it's another "P" or whether you see that is in here but another piece. That's also, and a little administrative comment, this is a risky comment because I'm going to say our schedule isn't as quite as tight as it was so now that is not meant as a license for everybody to deliver their long-winded thesis here, but we have, we are not going to hold the closed session with the consultants. So if we run over, run past 10:30 I think that's, that's fine, this is a very important topic and we needn't cut things off short.

Anne Simpson:

Thank you. You'll see in some of the presentations that are about to be made that the question of developing standards and guidelines some asset classes have identified that as their priority. In other asset classes, they're very active in that area already. But that's a good point. I'm only running ten minutes behind so that's pretty good given the territory we've been trying to cover.

**Segment 4- Part I: Implementation: Roundtable Discussion with CalPERS Board Members on Potential Focus for Asset Classes and Total Fund**

Anne Simpson:

What we're going to do now having just for me set out our three P's and maybe there's an all purpose "P" called Pieces, extra pieces that we need to put in, that we'll gather from this discussion.

What we're going to do now is each of the asset classes is going to have the SIO will put forward what they think they want to focus on under the three P's, their priorities, how they're going to approach this issue of performance and thirdly, where the P for procurement internal we should think of it that way too, as well as external. So Eric, why don't I turn to you to talk about potential focus for global equity. This is slide 12.

Eric Baggessen:

Good morning. Eric Baggessen, Senior Investment Officer for Global Equity. As Anne has laid out, there's a whole array of different considerations that need to be brought into this entire sustainability agenda. The global equity asset class has historically been an area where there's been a lot of engagement on the broad array of topics that resonate through this entire body of work. You're well aware of the fact that we've had environmentally aware strategies. We originally for example started with the negative screening aspects. We found that that was not creative to returns and we've now migrated into something we were trying to more positively wait exposure onto companies that we think will benefit and

participate in moving this agenda forward. We also have exposure into emerging managers, which touches upon the diversity characteristics at some level and providing opportunities for non traditional providers to get engaged in the whole asset management business. And again, the picture is not on ambiguously positive or negative, it's mixed. We've had good success in some areas and we've been challenged in others. In the area of corporate governance, we've had our engagement strategies and again somewhat mixed results. And I partly think that in many respects, the areas where we've had challenges in these segments is in not really understanding precisely what it is that we're doing. And this gets back to the questions that have come from Mr. Jelincic and also Tony Oliveira related to the investment opportunities set and whether these attributes become sort of betas over time. And I think that what we have to recognize when we invest in any mechanism that takes us away from the market capitalization weighted opportunity set, that in essence is an active position. That's an active bet that's being made. That there will somehow be a return to these attributes. For Mr. Jelincic's comment, We do not believe that we can create a superior investment portfolio by eliminating things from our portfolio or from the opportunity set. But that is not to state that we don't think that we can potentially make a better portfolio by reweighting those aspects in the opportunity set. I think that what we expect will happen and we see this, you know, really our expectation is consistent with this in the area of the work we've done with Rob Arnad at Research Affiliates and the fundamental investing. Even though that is not one of the topics we're really talking about here today that is a way of actively weighting a portfolio and we think that the earlier adopters, of changing and adopting that perspective in the market place will be rewarded with an alpha. But we do think to the extent that that alpha becomes evidenced that as time evolves that alpha will become a beta. And I really believe that one of the most important considerations of what we're trying to do with this is to create a framework by which CalPERS can consider and incorporate the, the topics and the issues that come up across our entire pool of constituents and across the entire market place. And do that in a way that's consistent with our fiduciary responsibility. I mean, this is one of the most important things that we need to take away from this work is doing something and creating a process to consider these elements, so that we're not just ricocheting off every idea which has historically been one of the attributes I think of CalPERS program. And I think that's evidenced in the 111 different statements that have been made, that people have attempted to pursue in different ways with greater and lesser degrees of consistency and efficiency. So I think a big piece of this is really trying to create a degree of consistency in the approach as to how we try to consider these elements. And then we can make rational decisions as to whether or not we actually believe there's value added to these components or not. So I think the comments so far have been actually helpful in thinking about that but that really is, in my frame of reference, that is one of the most important things that needs to come out of this is a process by which we assess and explore these issues.

So going forward, in the near term for global equity we think that the area that we can engage in and bring additional work into this entire topic, is related to our Focus List activities. That is a segment of the CalPERS activities in global equity that has been actually we think very successful in creating an actual economic return. And those Focus List activities, per Tony's comments, have evolved from being sort of just in a bully pulpit position to being one where we're actually encouraging real change within organizations. And we're trying to identify and effectuate the mechanisms that actually create that change. Whether that is shrieking at people or whether that's just working with them cooperatively to understand the prospectus. But we do think that the Focus List activities can stand the benefit of exploring a globalization of that activity. There are challenges that are attached to that globalization concept. You know, one is certainly identifying the right mechanisms to access and also to interact with managements outside of the United States in an effort to move forward change in the way that they do their business. Another aspect of that that's a challenge is in managing the resources necessary to carry out that activity. The Focus List activities and interaction that we have with company managements is very resource intensive. We send people to those companies. Those companies send people here. So we need to be somewhat circumspect as to what we think we can effectuate given the resources that we have. And we need to be very careful that the positions that we're advocating and the work that we're advocating is very consistent with the policies and the structures that come out of this Board in the form of our global principles of accountable corporate governance. All of that activity resonates back to those basic concepts that are contained within that body of work.

Another thing that has been a topic for a long time I think in CalPERS is trying to figure out a mechanism to monetize this engagement activity and the Focus List activity. And I think that's probably one of the near term areas that we can make real progress on, which is actually creating some differential investment exposure on the work of the Focus List team. And on the entire value creation precept that underlies that. So that's another area that we'll be working on in the near term.

On performance issues, to stay with Annes three P kind of a structure, for the longer term we think that what we really need to do is to identify and specify a body of research to be done that looks at the weighting of our global equity benchmark. And when I say weighting, that means really at the company level, on a bottom-up aspect, so if CalPERS truly believes that there is value attached to the statements that this organization has made on all of these different attributes that resonate in this entire topic area, we need to discover whether or not there are ways that we could restructure the weights in our portfolio, and again these would be active weights. They are not a passive exposure, this is an active weighting, which is evidence as soon as we move away from anything other than market capitalization. But is there a more relevant structure to the global equity benchmark that can then turn and tilt or twist those weights in a way that is consistent with the concepts and the ideas that have some through this



organization, and make us in essence live with the investment exposures that are consistent with, in some cases, rhetoric around a lot of these different topics. So I think a part of what CalPERS needs to do is to not be hypocritical about saying things on one hand and then having investment exposures that are not consistent with those statements on another hand. So I think we need to really look at that and I think there's potentially a long-term opportunity in changing that structure of that benchmark. But that opportunity will be matched with a long-term risk in the fact that we will be very different from other participants in the market place if we choose to do that. So that is a real, a real area and I think that's a critical area for us to work on.

On the procurement area, I think this is another near term exercise. Just recently we had a agenda item in front of the investment committee relating to how we have approached our brokerage allocation work. So this is where the global equity team when we select for our internally managed strategies, brokers to execute our trading activity, we have restructured that entire process to not only focus on the delivery of the economics and our fiduciary responsibility, but also to explicitly incorporate some of the organization's aspects and desires to include small emerging and potentially diverse firms in the roster of entities that execute our business. So we've really created a process around that in order to try to you know, create, create both the needed result that we obtain from the business execution, but also to incorporate a systematic process this kind of diversity and inclusiveness aspect that is very consistent with much of what CalPERS has had to say in the market place. When it comes to how we select and interact with investment managers, there has not been that systemic component, if you will, trying to bring in the values that CalPERS as an organization holds. So attached to this alternative solicitation process that you've heard some about and you've given us permission to move forward with that. As part of that process we are trying to systematically include a dialogue and a discussion and hopefully real decision points attached to how we interact with outside providers. Again, all of this needs to be done in a way that is consistent with our fiduciary responsibility. But we need to start asking the people that interact from outside of CalPERS and interact with this organization, we need to start asking them questions about the different areas that this organization, and this Board in particular, have put voice to the fact that it is meaningful to them. Whether that is diversity, whether that's governance, whether it's alignment of interest. All these different type of topic areas. So we're working with some academics attached to a program that we have with Northfield Information Service which is trying to build a structured assessment process around this alternative solicitation structure, to really incorporate some aspects that are much more qualitative. These are, they're typically not based on hard and fast numbers which are very easy to assess and figure out how to incorporate those in the decision making process. But Northfield and the academics are working with us to try to incorporate this more qualitative components into our decision making around this alternative solicitation process. So we think that that is one area that in the near term is gonna change the way that we interact with and procedure investment services,

information, perhaps technology and an array of other things that are required in the delivery of the global equity portfolio.

And I would suggest to you that we're already seeing the benefits of the cross asset class collaboration in that area. As we've tried to put metrics and concepts and real parameters behind much of these 111 statements that have come through this organization, we're having a measure of success I think in a cross asset class basis in interpreting what do those things mean. And the other asset classes are also looking at how we're trying to incorporate this structured decision making process into our own assessment of external providers. And they are starting to resonate to that structure as well. So I think process in this instance is your friend. It is what is required to make real systematic progress in these areas and that's exactly what we're trying, attempting to build into our procurement process. Mr. Cooney

Board Member Cooney:

Eric. It sounds as if the staff is working up a set of principles by which they can understand what, what those 111 separate initiatives that we're accreted over the years are all about. But I'm interesting in knowing what you are thinking about in terms of what process you think, what process would staff be comfortable with consistent with your understanding of our overall principles, to handle the 112<sup>th</sup> proposal for an issue. What process would you like to see in place to deal with that?

Eric Baggessen:

You know in reality that's perhaps a better question to be truthful with you, for Mr. Dear or perhaps Janine because it's not really what does global equity think about that perspective. I think it's what does the investment office think about it and what does the organization think. But we, we desperately in the investment office need a real prioritization of the issues that you want us to engage on. We cannot engage on 111 discreet statements, so we need to find a way to focus that body of work down into something that we can actually manage, you know, and deal with in conjunction with everything else that we need to do in our daily activity. So we all, we constantly have, part of our job as staff I think is to constantly bring you to a point where you create for us clarity and real prioritization of the things that you want us to incorporate in the way we execute this business. So we, again you know I think it's process, it's working down through how do we take that 112<sup>th</sup> statement and bring it, bring it to something that either dovetails with the other things that we're doing or if it's completely orthogonal and completely discreet from that, do we have the resources to deal with it.

Janine Guillot:

And I'll add one comment to that. I, that's why I think this concept of the unifying themes is so important and the three unifying themes, because from my perspective, those are very strong statements of intent that these are the areas in

which we'd focus. So the first, first screen if you'll say for whether or not we would want to do 112 is whether it fits under those three unifying themes. And then I think the second statement and I think Anne put it very well, under her priorities P is around capacity to deliver and potential impact on risk and return. And so we'd just run every proposed initiative through that kind of decision making process.

Board Member Oliveira:

Along that same line, Steve and I are thinking alike here. I, it'd be interesting and not a suggestion that you do, because that would probably be 113, is if you analyze those 111 how many of em were bottom-up and how many were top-down. I think this comes to Jane and Joe and Anne, especially with all of you asset class managers here, is that the staff needs to be empowered, which I hope they are, but empowered to push back. There has, the process has to have push back to where the strategies sounds great, it might be great, but unless you feel comfortable in addressing the Board or the investment committee, that particular proposal, 114 or 99 of the 111 is not appropriate in today's world. Unless you feel comfortable to be able to do that you, there would have always been this inherent conflict as you go through these processes is to kind of do 113 or 114 or back to 99 instead of addressing, this is today's world, this is what we think is right. And I believe you do that but I think you should always feel from the Board that you're empowered to do that in a comfortable way. Is that we have that kind of communication, that relationship. Because the ultimate goal, we can talk about all this but those sitting in the audience and those of that are currently retirees could listen to all this and say but your number one priority is to the members and their pensions. Your number two priority is to the world, and to the environment, to all those things and now we realize that they are all the same. And we don't have to reminded of that. We know what our primary fiduciary responsibility is. But the staff needs to be empowered like I say to push back and say wait a minute, that particular philosophy or particular...and you have done that when we've been asked to divest and do those things. So. I just, however we need to do that. Just remember as we do the process is the ability for you to say time out, this is why we don't think it's a good idea or is.

Anne Simpson:

Thanks very much. Eric. Is this a good point to hand over to Curtis?

Eric Baggessen:

Sure.

Anne Simpson:

So Curtis please, fixed income, your thoughts.

Curtis Ishii:

As you know, about 90 percent of fixed income is run inside, so this is really what we plan to do is try to better articulate the ESG factors. So if you think about it

when we discuss it with our analysts, the ESG factors are considered in a number of different areas. So it could be utilities and hydrocarbons, they're always considering climate factors, and things of that nature. So what we plan to do is kind of better articulate exactly what we're looking at. And we're always looking for things that will increase our risk return trade-off. So as Jane had indicated, the academic literature, especially in fixed income, is not real clear. There is more and more but it hasn't been clarified. So we hope to commission a study to kind of get more quantitative information. And if in fact what we believe is true, to educate and to disseminate this information to our portfolio managers and to our analysts. They, they are motivated. You set up the comp to find things that will make them smarter and make them better investors and if we can see that these things are in fact ahead of the curve, they will give them an advantage. So we hope to do a study.

To Mr. Jelincic's comment of why is this only external. We have set this external but for us it is also an internal thing. It is, there is no difference in our attitudes about creating value. Why would we just want to create value for the external managers. We would do it also for the internal managers. So, if we do find something, we will implement this and that's the procurement. We will create expectations for the external and we will do something for the internal too. And we will track this. These factors, many of them in fixed income's a little different because as you know, fixed income is a contract and you don't get the upside. So many of these kind of new innovative type of ideas are great but they're more great for an equity investor because if they work, they work in multiples. Whereas fixed income investors were, if it works, we get our coupon and get our principle back. So those are the areas in the three P's that we're working on and we hope to accomplish in the next three to five years.

Anne Simpson:

Thanks very much Curtis. Réal . I have a personal apology, we were in the wild throws of all this activity and maybe weeks into your arrival at CalPERS we're asking you with your team to develop things. But over to you. Your thoughts.

Réal Desrochers:

Thank you very much Anne and good morning to everyone. AIM has been very involved with this and when we look at the sheet that...thank you is it better? AIM for the E has a portfolio as you see, we say monitor and manage. E is for clean energy, clean technology, water resources. It's done mostly through venture capital investment. The S is for human capital as Anne was mentioning. And in there we have translated that into an investment program which is for diversity, new emerging manager. And G for governance for the alignment of interest. AIM has been involved with ILPA which is the Institutional Limited Partners Association. To incorporate the ESG factor into private equity, which is as we all well know, I consider a very young industry because private equity is only 20 years old. AIM has also been involved with the establishing the principle for

responsible investment in private equity. So when we look at it today, you have a portfolio of \$8.7 billion dollars invested in these activities of which \$1.2 billion dollars is what we considered clean technology, new energy, venture capital type of investment. I would say more early stage, more part of the future. And the \$7.5 billion dollars on the, on the diversity emerging manager and human capital. And I was surprised to see the number of 7.5 but that encompasses new and emerging fund that were created where CalPERS is investor. On the procurement, implement new manager. What we have in there is to implement new manager, due diligence, process that include ESG. We're doing that. The team also, we tried to stay very focused on a very fine existing manager and all new manager for alignment of interest. Over the last few months, we have designed also a tool that how we're going to screen and set up a manager. So really we're very involved with that on your behalf. And that's, that's what we're doing.

Anne Simpson:  
Thank you Réal.Ted.

Ted Eliopoulos:

Good morning everyone. Ted Eliopoulos. So I might take a few minutes talking about the, it's the real assets program in all. So each of Real Estate, Infrastructure and Forestland. And this is actually the, I'd say the third really in-depth time period that I've spent thinking about these issues with respect to this asset class in 2005 through the work that this CalPERS Board did at that time. Was pleased to see Winston Wilcox's in the audience today. He was instrumental in that effort. And then in 2008 I co-chaired for the National, it's called our PREA Institute, the Pension Real Estate Association, along with my peer from the GM corporate pension plan, a day and a half intensive look at environmental risk and performance issues for the real estate industry. And now in 2011. So it's interesting to see sort of that intensive look in 2005, 2008 and now 2011, and look at what, what's remained the same and what has changed. And I really compliment Anne and all the work she's done to help us organize these issues, because they're over that time period, there certainly is a proliferation of ideas and initiatives. As I look at this effort for the real assets group, we come, I come at it first in contrast to fixed income, for real estate it is overwhelmingly outside manager business model. So 100 percent of the investing that we do is through agents. And that informs, you know, how you look at these priorities, performance and procurement for the real assets group, and I think looking at what has not changed over that time period of looking at this is one of the key conclusions from the Mercer report which is the results are very much driven by manager skill and style set. And that is particularly so in these liquid asset classes with an outside manager agent model. And so when you take those key components and look at the priorities of E, S and G and particularly the climate, climate policy, climate change policy, the social issues, and the governance, it really focuses attention on liquid real assets where location is such a important factor, you know, for investing in fixed assets that

you're gonna own for long periods of time. The quality of those assets and how will they endure, how will they sustain over a long period of time and what will change and what will impact and what risks bring to those assets. Regulatory effect is a key, a key risk for owning these assets for long periods of time, especially in multiple regulatory environments.

And then just to touch briefly, we, the comment that Mr. Oliveira made about the agency risk. This key misalignment between the long term objectives of a CalPERS that looks out 20, 50, 100 years, and trying to execute these real asset strategies, you know, through a wide variety of human agents that have a much shorter time period. And you have contracts in place in our alignment of interest. That rewards managers on 5 and 7 year time periods. And certainly one of the experiences that we had is it's a particularly galling effect when the managers are rewarded during one of those briefer time period of 5 to 7 year period, and CalPERS has lost so much. So, the focus on alignment of interest I think is very important in this sustainability theme, because that's a key factor in how sustainable our CalPERS investment strategies over the long term.

For the Real Assets group, just by way of background before I get to ticking of our, at least the way we looked at the priorities and performance and procurement, I'll just go, much of this you know, but it's worth, worth stating, and certainly in the three time periods of that I've reviewed this, CalPERS has always been seen as one of the leading practitioners in the real assets area around these themes. In Real Estate, this Board adopted the energy efficiency goal of 20 percent reduction, which was very aggressive for that time period and many thought not, not likely attainable. Our Infrastructure policy includes very specific language about the prudent use of sustainable development methods and operational practices in its due diligence piece. The Forestland policy, this Board adopted the highest standards of independent certification for our forestland projects, so, and investments. In terms of social, real estate and infrastructure have adopted our responsible contractor program. In addition, in real estate, we have a long-standing urban real estate program which is again getting back to this theme of location, which is so important to these topics for real estate. Transit oriented design, community redevelopment, affordable housing, are all key components of that program. Our Infrastructure policy prohibits public sector outsourcing. Those are just some of the examples of the 111 pieces.

And then in the governance, I already mentioned the work that coming out of this last downturn on alignment of interest principles and models for the real estate group. So that's the background by which the real assets group looked at what, what could we bring as our priorities, performance and procurement initiatives. And for real estate, the one that I want to underscore since we've now culminated the five year energy efficiency goal, we really looked at what are, what are some of the options to take the next step. And what we are recommending is that CalPERS and our investment manager membership become members of the GreenPrint Foundation which I'm sure we'll be bringing

to you more information at a further date. But GreenPrint is an organization that is committed to reducing the real estate industry's carbon footprint for institutional investors and it has created an index which is meant to collect all the current carbon footprint information of all the participating properties and provide a benchmark to measure the institutional investors. And a great majority of real estate managers that we contract with, other pension funds contract, are all becoming members of this index and we think that is a key priority.

For Infrastructure and Forestland, there's, for Infrastructure especially, there's work to be done to really research and identify what's the appropriate reporting standards. Infrastructure has a challenge in that it invests in different types of assets, you know, from an airport to a water quality treatment facility. So one reporting framework doesn't work for each asset, and that's the priority for infrastructure. And for Infrastructure and Forestland, the priority going forward is to work on alignment of interest standards for those asset class.

In terms of both performance and procurement, we really need, and it's underlined by the research in this binder, and the work, is a real effort to develop our due diligence and our performance measurement, really across real estate, infrastructure and forestland. Much more standards efforts to include the framework, a checklist to evaluate managers, both ex ante and during our investment relationship. So those are the real assets priorities, performance and procurement initiatives.

Anne Simpson:

Thanks very much Ted. Farouki, risk and asset allocation.

Farouki Majeed:

Morning. Thank you Anne. So asset allocation and risk management. How are we involved in all of this. Luckily for me in 2010, '09 in fact when we started CalPERS participated in a study along with 14 other global institutional investors titled Climate Change Scenarios- Implications for Strategic Asset Allocation and Mercer was, coordinated the study. That is in, behind the last tab in your report. It's a fairly detailed look at the implications of climate change risk for strategic asset allocations. Just to give you some, some brief points then. If you would recall the last asset allocation we did we structured it along the lines of broad macro economic risk factors and how do the asset classes that we had before fall into those pockets and so on. That's the approach that we took to our strategic asset allocation. Interestingly enough, most of the study takes a similar approach to trying to assess the impact of climate change risk on strategic asset allocation. So, you have the fundamental risk factors such as GDP growth, interest rates, inflation, etc. Those would, to the extent that these risks impact those factors, that's something that we probably need to consider when we next do our strategic asset allocation. But it's not as easy to do. What would be the impact on growth and inflation and other things depending on how these risk factors play out. In the short term, it appears that the conclusion is that that's

not, it's not that significant and not something that you can easily, easy to get a handle on. But clearly in the long term, those risks see to be much more pronounced on these broad risk factors. So that's something that we're gonna have to look at as the progress along our, the strategic asset allocation exercises that come along.

But one of the other things that we can do is to look at the diversification of our assets across all the various pockets and see to what extent can we in a qualitative way try to address some of these risks. I think most of the study points out that there are certain assets that are much more sensitive to climate risk and the incorporation of those assets in the portfolio helps to mitigate those risks. And those types of assets are listed as infrastructure, forestland, commodities and then private equity and real estate and so forth. So we were, as you know attempted to do some of that already in our portfolio. We do have some growing exposures to some of these areas such as infrastructure and commodities which are small at this point in time.

In terms of performance, I think what we probably need to do, I'd probably echo some of the comments that Eric has made. In terms of trying to look at all these various initiatives that we've had and look at what is the impact on the total fund, risk and return. What has it done to the strategic asset allocation that we have had, and to try to, you know, in a quantitative way try to assess those risks. That's probably going to be a complex exercise but I think it's nonetheless, something that we probably need to think about and this, this project here to integrate the ESG across the Board here probably that fits into, to your agenda here Anne.

So those are my brief comments. One of the things that I would point out to in the Mercer study is also they've laid out and we've been involved in the discussions, a fairly good framework to assess the risk, climate change, risks for various asset types, along the TIP framework which is the technology, impact and policy framework. And I think that gives us a tool to kind of assess risks going forward. So there are risks here but there are also opportunities. For example, under the technology area, I think the Mercer study points out that there's going to be huge amounts of investment flows in terms of new technology to adapt to climate change risks. And that's estimated to be somewhere in the 4 to 5 trillion dollars, probably present a lot of opportunities in the various asset classes to take account of and so on. So hopefully we'll try to use that framework to assess what we're doing in the strategic asset allocation area going forward. Thank you very much.

Anne Simpson:

Thank you Farouki. So finally, before opening for discussion, our chairman, do you have a target time that you'd like us to finish? (At 11:00) Very good. So, the last piece to put to you is really proposals for the total fund. Things that CalPERS could consider to take this work forward. So on the priorities, the first



recommendation we have is to replace the many ESG and I think other letters, D for diversity or E for emerging, that we replace these labels with the term sustainable investing. Be grateful for your thoughts on that. But it seems to be we need a conceptual framework which ties this directly to the funds financial objectives.

Secondly, we think it would be useful to wrap around the 111 or more statements and initiatives to have a statement on sustainability which will frame the work for the total fund attached to its financial objectives. Attached to the fiduciary obligations of the fund.

The third area of recommendation is for us to develop and to publish a sustainable investment report for 2012. This would require continued work and effort with the cross asset class team who deserve tremendous credit for taking this activity to this stage. We think a report would actually be a useful discipline. It will also ensure that we set ourselves some targets and we report on progress. And I think it'll be a useful tool for you as the Board holding staff accountable. Even for when we say no, when necessary. On the P for performance, we think a useful project is going to be to review and bring together the results of the different asset class projects on research around data. Those asset classes which don't consider they have good data, have got an idea about what to commission, from whom to commission, and at a point in the future, perhaps this is a two to three year cycle of looking at this, we ought to pull that all together and see where we are on the sustainability data. We also on the performance dimension, consider we need an implementation plan as opposed to the warm words or the rhetoric or the shrieking as Eric would have it. But if we're going to have an implementation plan, it means that we identify key performance indicators, not just the warm words and the statements of good intent. Real action that we want to be specific about. And as I mentioned earlier, we think there's been tremendous benefits from this cross asset class team working together. It's been an exercise in mutual education and out of it have come some terrific ideas. And I think an opportunity for better understanding and making what we do more consistent. So I thank you to everybody who's been involved. And thank you to the SIOs because you volunteered superb team here, and you've been extremely busy.

On procurement, each asset class in some way or form wants to develop a framework, an expectations document and alignment of interest, process, due diligence, checklist, and so forth. We think for the total fund that will evolve into a uniform process to enable us to identify and then collect relevant disclosures from external and internal fund managers. We don't want to force the process because that would be unnatural. It would probably also mean that we would trade some quality and innovation for uniformity. We need to less devolve and be willing to learn lessons as we proceed. But the objective would be to have a consistent approach to procurement.

So the final slide takes us back to the last Board discussion on investment beliefs. This track of work has come through a separate channel which Farouki has been managing. But one of the investment beliefs that was put forward for discussion at the last Board meeting relates to this area of work. And therefore in order to tie together that discussion with this discussion, you have a summary of the various investment beliefs that were debated and the views of the Board at that stage on both, which beliefs are important and some thought about how to formulate the belief. In other words, if there's something out there on risk for example, how do we capture the word, the wording is quite important. So I think at that point Joe, we've probably on our side presented our thoughts on this subject. We realize it's a work in progress. Feedback from the Board is extremely valuable, so thank you for taking this time to have the workshop. It's very important that we get your guidance while we're still developing these ideas.

**Segment 4- Part II: Implementation: Roundtable Discussion with CalPERS Board Members on Potential Focus for Asset Classes and Total Fund**

Board Chairman George Diehr:

Thank you for your, well your whole presentation. Your comments and everything. I have a few reflections. A number of them you haven't touched on. I met with a consultant about a week ago and I asked what was his evaluation of ESG, and he said well all things, if all things are equal between a couple of investments, if you consider ESG factors, you're, you're probably not likely to do worse by taking them into account. The problem which ties to the, the added investment belief here, number two in the added list, is that, is the issue of complexity and I think that's a thing we have to, may have to take a separate look and not just with respect to ESG but everything we do. Are we, are we spread too thin in terms of a number of different asset classes or strategies that we have. So, there's, there's a need for, for balance in the ESG in the sense of the effort and time and money, staff, energies we put into this, that we, that we get a return and it has to be against, you know, what alternative ways we might use that research. We have to, as Larry said, we need to look at the research, that's, I agree that's very important. And, and also we need to keep into account, or take into account that a lot of our investing is, is more or less passive and so that may raise the quick question of this, you know, should we be putting additional effort in ESG, should it bias us or tilt us toward the policy and the regulation end of things. In the, getting back to the science end, I'm, you know, there's a lot of, science I think decided that global warming is real. There's a few who disagree for whatever reasons, but everything is certainly not clear. I think, you read about fracking, it sounds that that's really not settled or that's such a good idea or a bad idea, or just how bad it is. Because you have to look at trade offs in the nuclear arena. It seems to me the, my feeling is the world's kind of overreacted to that in the long, long term. It seems hard to not, not have nuclear energy creation. And again you've got to look at what the trade offs and the alternatives.

Tony's comments about market pricing, particularly I guess the market pricing in ESG factors, eventually that will probably sort of work it's way out, although as you see from our beliefs, I think it's a true one that there'll always be inefficiencies in the market, so there'll always be places, companies where we can exploit those inefficiencies to our advantage. We also need to be careful at the same time, though it must not be an issue the Wall Street Issue that goes by, or at least not a week where there isn't a full page ad by the energy company telling us how wonderful they are and how they're taking everything into account. Now is that driving up their stock prices, so let's be careful about getting on some green bandwagon that isn't, that isn't real. So, I think, by the way, it all does come down to sustainable investing, overall look at the total activities we do. Sustainability of the fund too and of the system. And I don't know if there's a question here but I again, I applaud the work you've done.

One comment on, on the next steps. I think, I think we should have input from our consultants along the way as these, as the recommendations are developed. I would like to see their feedback on that. Thank you.

Anne Simpson:

Steve, then Priya, then JJ. And apologies for first names, it's quicker.

Board Member Coony:

With regard to warm words and rhetoric, I'm gonna make a risky suggestion here, and that is I think the unifying principle of sustainability is an excellent choice of words except I think that's a buzzword that's about to be used up. And I think in another couple of years, this will, this will look very old. So I would like to charge our consultants, our staff, other Board members, to come up with a synonym for sustainability that will be owned by CalPERS. That this will be our idea. It captures the same thing. It might take more than one word, don't know. But I would drop that baby and go to, and lead the world rather than follow the folks who are using this one.

Anne Simpson:

Very good. Do the right thing, for example. Maybe we'll have a CalPERS competition.

Board Member Mathus:

I wanted to draw a really strong distinction between SRI which has been sort of the buzzword in the approach to ESG for the past couple of decades I think in the investment industry. And what we're considering today. I think SRI, socially responsible investing, is really driven by some social objectives as opposed to investment and performance objectives, and risk management objectives, which is what I think we're really talking about today. So I would never argue that CalPERS ought to do something simply based on some consideration of a social issue. But in the sense that social, environmental, governance factors impact the risk and potential performance of our portfolio, I think we would be really, it would

really be inadvisable not to consider those factors. And I recognize that not all of them are equally quantifiable and but I think there's a place for investment judgment also here that we need to exert. And I think we do it, we do it anyway and don't really acknowledge it in various other forms. But I don't, I think we're a little bit behind, we collectively as investors, I don't think just CalPERS, but a little bit behind in considering these really important and impactful risk parameters. So I feel very strongly this is the right direction for us to be going in. Whether it's sustainability or whatever the catch phrase ends up being, I think integrating it across all of our asset classes is critical. I'm really pleased that we've had this interdisciplinary inter asset class team and I hope that that team stays together and continues to do some really fruitful work for the organization in figuring out how exactly to integrate this into our investment strategy and risk management approach.

I do think that having a monthly report would be useful for the Board. I think we used to have sort of a corporate governance report that came before the investment committee fairly regularly. And that seems to have dropped off somehow along the way. But I do think that monthly or quarterly, some kind of regular report would be really useful for us in tracking both the progress we're making towards integration and also monitoring some of the approaches that we implement along the way.

And I think it's critical that we use this way of thinking to form our investment beliefs, so I, I know that there's still, you know, the vote that we had at the investment, I'm sorry at the offsite, was kind of a mixed bag, but I think it was a little bit unclear whether we were voting on language or whether we were voting on the concept as a whole. And I think it bears further, I mean I'm really glad we're having this conversation today. I think it bears further conversation by the Board, in fact all the investment beliefs do. And really articulating those in a cogent fashion is going to be important for directing the future of this organization, as an investment organization. So I'll leave my comments there but I'm really pleased that the organization as a whole is really beginning to grapple with these, I think critical risk management and performance issues.

Board Member Jelincic:

The suggestion to replace the ESG labels with sustainable investing. Words have meaning. When you decide the core is defensive and value added is defensive plus, that has meaning. I'm not sure, I haven't been able to figure out exactly what the change is but why are we changing the words, why are we moving away from the ESG labels, what do we intend to accomplish by changing to sustainable investing? Do we really mean something different? And I'd kind of like to hear some comments on that. But, and the developing and implementation plan with key performance indicators. I think before you do that you really need to define what the goals are because once you decide what you're trying to do then you can figure out what the implementation plan ought to be and we'll point out that you get what you measure, so we need to figure out

what it is we actually wanna get so that we measure the right things so that we induce it. But I would appreciate some comments on what's the goal of the word change.

Anne Simpson:

On the word change, we've got not just ESG we have other terms throughout the 111 initiatives. For example, emerging managers, diversity, responsible contracting, just some examples. The idea is to find a term, maybe not sustainability, Steve's point might not be the right label, the idea is to say let's see if we can express the unifying theme across the portfolio in language which is reflecting the fiduciary obligation regarding risk and return. So it's to bring clarity and focus, that's the purpose. Your point on defining the goals is a good one, the proposals from the asset classes are intended to be the first step in that direction. If the Board supports the ideas that have come forward from the SIOs, they will become the objectives that will then be the end goal, the implementation plan so for global equity, if Eric is proposing to explore monetizing a globalized focusness, we'll say well what does that mean? Is it that we'll take our top 10 markets, we'll look at particular issues and what are they, are they governance issues, are they specific to emerging markets for example, which markets will we do that in, and if it's going to be monetizing, does that mean we run a dummy portfolio in parallel or do we allocate real money? Is it a co-investment program or a tilt? So each SIO has got an idea, a proposal that's the objective, the implementation plan will say, or define it specifically and give a time period and resources to be put to that consistent with the other objectives of the asset class.

Board Member Jelincic:

One of the other issues is Eric raised the issue, that this really is an active bet, and as we make that active bet or choose not to, we need to figure out how are we getting compensated for the active bet? Are we getting compensated enough to offset the risk? And its not clear that the data or information we need to make that judgment is yet available, I mean it's in the process of being developed but I think that's, I mean intuitively yes these make sense but I'm not, but we really do need to figure out, are we getting paid for the incremental risk.

Anne Simpson:

Mr. Dunmoyer.

Board Member Dunmoyer:

Thank you. Just a couple of quick comments. I'm not sure what term we'll use but I'll call it for today ESG and sustainable investing combined. I guess for me it's more an issue in framing this, it's more of the issue in which filter you use first. I think the fiduciary role is overarching filter but as we look at investment options, I'll use simplistic things because that's how my brain works. But if we had Company A or Fund A which invested in energy companies that had a better track record on the environment and Company B that didn't have as good a track record but Company B's rate of return was substantially better, what will we do?

How does ESG or sustainability impact that decision? And I don't think it has to be either/or, I led the insurance industry 15 years ago into doing investments in the inner city communities with then Commissioner Garamendi and we didn't quite take the path that he wanted at the time but we found a way to invest in California's inner city communities and make a substantial rate of return but it took a lot of time, we still filtered first the rate of return as our primary indicator. And I'm not sure as a fiduciary, you know, obviously if you have Company Fund A and Fund B and they're both making the same rate of return and one meets our ESG sustainability goals then it's kind of a no brainer. Now obviously if it's better it's even an easier no brainer. But often times that's not the decision, the decision might be well this is a publicly traded company that's not unionized, this one is unionized, the non-unionized makes a lot more money because they don't pay their workers as much. It might be that simplistic but then what would we invest in, what would, the Board might feel differently, different Board members might take that issue quite differently. So I think for me just, you know, as we look at all these different activities, I guess it's called sticking to our knitting, I think our primary goal on the investment side is to make the most positive return we can. We can leverage our strength, our size, our scope, to influence these issues but if all the sudden we're saying well we don't really wanna hit our 7¾ this year because we want to meet our ESG goals, that's where I think we have to be much more careful and we have to change that. We have to realize that our primary responsibility is to invest properly and then to leverage secondarily these rules. And I don't know if that's necessarily shared by my colleagues, that's my opinion on this, but I do think it is what drives us as fiduciaries and it's my read of what the rule is and I realize there's at least 15 opinions if there's 13 of us. But that's just you know, the dynamic that I'd like to kind of keep in mind that if staff hits a home run in ESG and we had a 2.3% return last year, those are things that we want to make sure that we're really sensitive to so it's a balancing act. But to me the primary role is in our investment focus and the secondary role is our ESG sustainability and I just bring that for discussion.

Anne Simpson:

No, it's certainly the way that we've approached this project is to say the fiduciary responsibility is the foundation, that's a non-negotiable, it's a given, there's no choice, that's what CalPERS is, a fiduciary investor. So how do we use ESG sustainability and the new word yet to be presented, how do we use that to improve the quality of our decision making, and it's not going to be a cookie cutter approach. But if we know there are issues out there, traditional economics, how I was taught, where does wealth come from? Three forms of capital: financial capital is why you worry about governance, human capital, that's why you pay attention to what's going on with employees and labor, and physical capital, that's why issues around water or the physical, people now talk about social capital as well, the impact of issues like reputation and ethics. But I'm still very comfortable with old fashioned economics and if we pay attention to those forms of capital and think about the data and think about the information, I'd say it is enhancing CalPERS ability to make good investment decisions. I certainly

wouldn't see it as a way of substituting, it would be a way to improve the quality. But that's the way we've approached it on this project.

Board Member Moret:

Just a couple of comments. We tend to use diversity and emerging as interchangeable and they're not. And we gotta come to grips with that eventually, we're refusing to deal with that, okay, whatever the definition may be. Diversity is clearly gender and ethnicity, emerging is in the eye of the beholder and we tend here to make it either first or second time fund or the size and the eye of the beholder could look at research affiliates when they started and call it emerging and I'm sure they did, okay, or double line if we were to mess with them because they are, just started, first time, broke away. So I think we, whatever we start calling this we better start at least putting an emphasis on putting money in the hands of women and minorities because frankly when you look at the numbers right down, I don't care if it says 7.5 billion, it's what's in the hands of women and minorities is a fraction of that. So we could be proud of having money with emerging managers but they're not the way I define them and we, and I urge this Board to deal with that sooner than later. Thank you.

Board Member Jones:

Yeah, thank you for the presentation, a lot of valuable information. And I support what Dan was saying about our primary fiduciary responsibility is returns to pay our members benefits and their beneficiaries. But I think this may be an opportunity for us to use a process to get to some of the concerns that Lou has raised because if these 111 initiatives go through some kind of process and evaluated to see what that original goal was if we had one uh, and then compare whether or not they're achieving those goals so why would we move it on into this new initiative? Maybe we should rethink it and drop it and forget about it, I know it takes time sometimes to make changes in some of these large initiatives, but I think we should use a process to evaluate, this is a golden opportunity to look at something we've been doing for years in certain areas to make a change. And so I think we need to you know, keeping in mind that our ultimate goal is that 7¾ return but we've used reports to say that some of these initiatives do make a difference, like the corporate governance, we got a report that says you know, our focus list, it provides additional return to performance. So if we have that kind of data that's available for other of these initiatives here we should use it, and if it's not reaching the bar then we should change it. So I think we should use this as an opportunity to filter a lot of that stuff out.

## **Segment 5: Next Steps & Closing Remarks**

Board Chairman George Diehr:

No other requests to speak. Joe, do you have any closing remarks?

Joe Dear:

First an appreciation of the Board listening and to the outside presenters that came and did their work, to the SIOs for taking specific public commitment...

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Board Member Jones:

Excuse me Joe, I do have one question.

Joe Dear:

Sure.

Board Member:

In the report, discussion paper prepared for CalPERS Global Peer IESG, in there you make reference to faith based initiatives. What are you referring to?

Jane Ambachtsheer :

Sorry, in regards to the research?

Board Member Jones:

Yes.

Jane Ambachtsheer:

So faith based investors would be investors who are seeking to align certain faith beliefs with their investment outcomes. So traditionally it would be around screening, so identifying activities that they don't wanna be associated with, whether it's alcohol or pornography and screening those types of activities out of the portfolio. Sins stocks.

Board Member Jones:

Okay, thank you.

Joe Dear:

Think of a pension plan for ordained ministers.

Jane Ambachtsheer:

Right, yeah.

Joe Dear:

Well, again to continue with the thanks. And we will take the comments from the members into careful consideration and come back to you this fall with an implementation plan. We got a lot of good comments and observation but I wanna respond by reiterating that nothing changes our fiduciary duty and the risk and return of the portfolio is the primary objective that we all have to manage. My hope is and our belief is as staff that by trying to integrate both all of these issues, the "E", the "S", and the "G" and the rest, and put it in the framework of our regular conduct of business in the fund, not as an add-on or an extra program or something that's done when somebody comes and has an idea, but something that is part of the way we do business, is the way of achieving that primacy of fiduciary duty and making decisions in the context of appropriate risk and return. So we don't worry about is it a governance issue or an environment



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issue is it a risk to the portfolio, is there an investment opportunity to be taken care of, and do we have the capability of taking advantage of that opportunity? That's what this is about. I hope by defining in this way that we can say these are our strategies, these are our priorities, and when the new one comes up we can say we have an objective, we're working on it and we can resist the scatter shot approach that can come about if you don't have a clear focus about what this is about. So Anne is going to review all of these policies, put them into kind of one coherent document, we're going to report on these activities routinely and I think that will help keep us moving forward. But again, my thanks to everybody who's been here. This is really not about more, it's about better and I think we've taken a good step this morning in that direction. So thank you all very much.

[Clapping]